

The Role of Mortgages: A Case for Formal Law

Guanghua Yu^{*}

Abstract

Law and development scholars have downplayed the role of formal law in China's economic development in favor of informality. Through an analysis of the Chinese mortgage regime, this essay shows that formal legal institutions have in fact made a positive contribution to China's economic development. The economic theory of self-enforcing contracts suggests that a contract is self-enforcing if the expected future gains from adhering to the contract exceed the current gain from a violation of the contract. In addition, economists argue for the importance of using informal contractual means to enforce contracts. For example, contractual parties may "take hostage" from the other contractual party to support exchange. (The term "hostage" signifies valuable property transferred by one contracting party to the other that may be forfeit in the case of breach of promise or non-performance by the transferring party. In 1983, Oliver Williamson argued for the importance of using hostages to support exchange in informal contractual settings.) But hostage used in informal contracts normally only deals with two contractual parties. This essay uses evidence from China's developing formal property law covering mortgages to argue that when built upon and enforced by the formal law, the device of mortgages can cope with conflicts of interest among a large number of creditors. Analysis of the Chinese mortgage regime shows that there are clear limits to reliance upon informal contractual arrangements in Chinese economic development.

I. Introduction

Contract law facilitates exchange in the sense that it makes the gain

^{*} Associate Professor, Faculty of Law, The University of Hong Kong; S.J.D., University of Toronto, 1996; J.D., University of Toronto, 1993; LL.M., Osgoode Hall Law School, York University, 1988; B.A.; Shanghai Maritime University, 1985. The author thanks the University of Hong Kong for a Small Research Grant.

from trade more predictable. Efficient exchange, however, requires the existence of clear property rights. North claims that “the inability of societies to develop effective, low cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third world.”¹ Some evidence in China and elsewhere is consistent with North’s claim.² Enforcement of contracts, however, can be carried out by informal or formal means.³ The economic theory of self-enforcing contracts suggests that a contract is self-enforcing either because the expected future gains from adhering to the contract exceed the current gain from a violation of the contract.⁴ It is obvious that self-enforcing agreements are not feasible if the sequence of occasions for transactions has a definite known last period.⁵ In addition, highly uncertain conditions are not conducive to self-enforcing agreements.⁶ In the modern world, however, unexpected things occur very frequently. The Asian financial crisis, the recent US financial crisis, significant change of cost conditions resulting from commodity price fluctuation are some of the unexpected events which are likely to affect the payoff of contractual parties. To support exchanges, contractual parties may take hostage from the other contractual party.⁷ If hostage is used, non-performance by a contractual party will result in the loss of or harm to the hostage.

This article argues that hostage used in informal contracts normally

¹ Douglass North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), at 54.

² Guanghua Yu and Hao Zhang, “Adaptive Efficiency and Financial Development in China: the Role of Contracts and Contractual Enforcement”, 11(2) *Journal of International Economic Law* 459 (2008); Lisa Bernstein, “Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry”, 21 *Journal of Legal Studies* 115 (1992) (The change of resorting to formal dispute resolution in the diamond industry supports the hypothesis that in the presence of a credible formal legal regime, when the need arises to go beyond the ethically derived, extra-legal norms that govern the transactions, it seems likely that the formal law will be more frequently used); Simon Johnson et al, “Courts and Relational Contracts”, 18 *Journal of Law, Economics and Organization* 221 (2002) (finding that effective courts foster the establishment of new relations and court enforcement is more important when the supplier involves specialized inputs).

³ For a review of the role of informal and formal contracts in economic development, see Michael Trebilcock and Jing Leng, “The Role of Formal Contract Law and Enforcement in Economic Development”, 92 *Virginia Law Review* 1517 (2006).

⁴ Lester Telser, “A Theory of Self-enforcing Agreement”, 53(1) *Journal of Business* 24 (1980), at 42.

⁵ *Id.*, at 44.

⁶ *Id.*

⁷ Oliver Williamson, “Credible Commitments: Using Hostage to Support Exchange”, 73 *American Economic Review* 519 (1983).

only deal with two contractual parties. Built upon and enforced by the formal law, the device of mortgages is able to cope with multiparty conflict of interest. Contrary to the prevailing view that formal legal institutions do not play any important role in China's economic development,⁸ this article makes a case that the formal legal institution does make a difference in China's economic development. Section II of this article explains that a formal legal system is essential to deal with problems arising from mortgages. Section III uses empirical evidence on the increasing use of mortgages in China to show the role of mortgages in facilitating bank lending. Conclusions follow in Section IV.

II. The Device of Mortgages and Formal Law

When the present value of the expected future benefits from maintaining an agreement exceeds that of the expected benefits from a violation of the agreement, the agreement becomes "self-enforcing." According to Telser, the only recourse of the non-breaching party in a self-enforcing agreement is to terminate the agreement.⁹ Williamson shows that "the use of hostages to support exchange is widespread and economically important."¹⁰ Using hostages to support bilateral foreign relations in China can be traced back to 720 B.C.¹¹ Viewed from the perspective of using hostage,

⁸ Donald Clarke, Peter Murrell, and Susan Whiting, "The Role of Law in China's Economic Development", in Loren Brandt and Thomas Rawski (eds), *China's Great Economic Transformation* (Cambridge, New York: Cambridge University Press, 2008) (observing that it is impossible to make the case that formal legal institutions have contributed in an important way to China's remarkable economic success), available at http://papers.ssrn.com/sp13/papers.cfm?abstract_id=878672; Graham Mayeda, "The Role of Different Domestic Norms in Law and Development Reform: Lessons from China and Japan", 51 *McGill Law Journal* 547, 582-83 (2006) (pointing out by citing others that the Chinese legal system offers little protection to private property rights); Tom Ginsburg, "Does Law Matter For Economic Development? Evidence From East Asia", 34 *Law & Society Review* 829, 830 (2000) (observing that law has not played a major role in Asian economic growth although he raised the possibility that existing evidence is not sufficient and that a more detailed study of Asian legal institutions would elucidate their central importance in Asian growth); for a recent introduction to the Chinese legal system, see Bin Liang, *The Changing Chinese Legal System, 1978- Present: Centralization of Power and Rationalization of the Legal System* (London: Routledge, 2008).

⁹ Telser, *supra* note 4, at 27.

¹⁰ Williamson, *supra* note 7, at 537.

¹¹ Lien-sheng Yang, "Hostages in Chinese History", 15 *Harvard Journal of Asiatic Studies* 507 (1952).

the expected future stream of benefits from maintaining a self-enforcing agreement can be viewed as hostage. Violation of such an agreement will result in the loss of the hostage. That is the termination of the agreement and the resulting loss of the expected future stream of benefits.¹²

Klein and Leffler deal with the issue of quality guarantee in sales transactions.¹³ A major finding of their paper is that “market prices above the competitive price and the presence of non-salvageable capital are means of enforcing quality promises.”¹⁴ If the seller cheats by lowering the quality standard in a transaction, the spread of complaints of consumers will result in reduced sales or loss of sales. When reduced sales or loss of sales occur, the seller will either lose the market price above the competitive price or suffer loss on the non-salvageable asset investment. Viewed from that perspective, market price of the seller above the competitive price and the loss of benefits from using the non-salvageable asset because of the reallocation of the asset for the next best alternative can be regarded as hostage. Advertising¹⁵ and developing products with brand names¹⁶ normally indicate that a company is investing in non-salvageable assets and the presence of a current and future price premium.

Klein argues that a franchisor acting as a franchisee’s landlord can discipline an opportunistic franchisee by imposing a sunk-cost penalty on him. Franchisors can better

...assure quality by requiring franchisee investments in specific ... assets that upon termination imply a capital loss penalty larger than can be obtained by the franchisee if he cheats. For example, the franchisor may require franchisees to rent from them short term (rather than own) the land upon which their outlet is located. This lease arrangement creates a situation where termination can require the franchisee to move and thereby impose a capital loss on him up to the amount of his initial non-salvageable investment. Hence a form of collateral to deter franchisee cheating is

¹² For a similar view in the context of international trade relations, see Beth V. Yarbrough and Robert Yarbrough, “Reciprocity, Bilateralism, and Economic ‘Hostage’: Self-enforcing Agreements in International Trade”, 30(1) *International Studies Quarterly* 7 (1986), at 11.

¹³ Benjamin Klein and Keith B. Leffler, “The Role of Market Forces in Assuring Contractual Performance”, 89(4) *The Journal of Political Economy* 615 (1981).

¹⁴ *Id.*, at 618.

¹⁵ *Id.*, at 630.

¹⁶ *Id.*, at 632.

created.¹⁷

In business franchising, the hostage may be the capital cost of the vulnerable sunk investment.¹⁸ Alternatively, the hostage may be the value of future above-normal profit earnings for the franchisee.¹⁹ Termination of the franchising contract will result in both types of loss. Empirical evidence on franchising relations in the United Kingdom, however, does not strongly support the view that termination of the franchising contract will necessarily result in the loss of location specific investment.²⁰ Lease termination is subject to very careful private regulation including the inclusion of arbitration clause, renewal, or buy back of franchisee's assets.²¹ The purpose of lease control by the franchisor is rather due to the high cost in finding a suitable new site.²²

The term "mortgage" refers to a transaction whereby a debtor or a third party ("mortgagor") uses certain property ("mortgaged property") as security for an obligation without the transfer of the possession of such property. If the debtor fails to fulfill his or her obligation, the creditor ("mortgagee") has priority over the mortgaged property.²³ Viewed from the perspective of hostage, mortgaged property can be considered as hostage. This is so because the failure of performing the obligation by the debtor will lead to the disposition of the mortgaged property. When the mortgaged property chosen to secure debt consists of assets whose value in the borrower's business exceeds their market value, the harm to a borrower that defaults under a mortgage contract is the loss of the idiosyncratic value. Since the particular mortgaged property may be used to secure several debts, default on any of the debts will result in the loss of the hostage. Put it another

¹⁷ Benjamin Klein, "Transaction Cost Determinants of 'Unfair' Contractual Arrangements", 70 *American Economic Review Proceedings* 356 (1980), at 359.

¹⁸ *Id.*

¹⁹ See Benjamin Klein, Robert Crawford, and Armen Alchian, "Vertical Integration, Appropriable Rents and the Competitive Contracting Process", 21 *Journal of Law and Economics* 297 (1978).

²⁰ Antony W. Dens, "A Case-Study Analysis of Franchise Contracts", 22(2) *The Journal of Legal Studies* 367 (1993).

²¹ *Id.*, at 372.

²² *Id.*, at 376.

²³ For a discussion of the roles of secured debt in alleviating adverse selection problems and moral hazard problems, see George G. Triantis, "Secured Debt Under Conditions of Imperfect Information", 21 *Journal of Legal Studies* 225 (1992).

way, the probability of losing the hostage in mortgage contracts is greater than in other simple bilateral contracts.

The above discussion on the hostage used in self-enforcing contracts and in mortgage contracts raises a very important question on the institutional difference between simple self-enforcing contracts and mortgage contracts. After all, a simple bilateral mortgage contract is also self-enforcing. When a piece of mortgaged property is used to secure separate debts, the mortgagor faces several secured creditors, mortgagees. The device of mortgages can be used to deal with multiple creditors. The rest of this section will explain why the device of mortgages is different from simple bilateral self-enforcing contracts.

Williamson has remarked:

The study of contract in both law and economics has mainly emphasized legal rules and technicalities. Such an orientation is supported by the implicit assumption that the courts “work well.” Whether they work well or poorly, however, requires a comparative institutional assessment.²⁴

I take Williamson’s suggestion to carry out a comparative institutional assessment to examine the mortgage regime.

In Telser’s simple bilateral contract model discussed previously, each contractual party calculates whether s/he is better off continuing or terminating the relation with the other party. S/he terminates the contractual relation if and only if the current gain from termination exceeds the present value of the expected gains from continuing. Such a self-enforcing model becomes problematic, however, when it is extended to multilateral agreements. Discussing in the context of international trade, Beth Yarbrough and Robert Yarbrough have observed that “delicate balancing of costs and benefits may be difficult to accomplish with large numbers of participants.”²⁵ Different rounds of negotiating multilateral trade agreements show how long and difficult it is to reach multilateral trade agreements. In the case of a mortgage contract, a debtor may face numerous creditors. Furthermore, when a mortgage contract is enforced upon default, the relations between the borrower and secured creditors normally come to an end as far as the particular mortgaged property

²⁴ Williamson, *supra* note 7, at 537.

²⁵ Yarbrough and Yarbrough, *supra* note 12, at 20.

is concerned.

Klein and Leffler's model deals with promises on quality which cannot be verified by a court. If consumers expect the product to be of high quality but the seller offers a low-quality product to the unsuspecting buyers, the seller can reap a short-run profit. "Cheating will be prevented and high quality products will be supplied only if firms are earning a continued stream of rental income that will be lost if low quality output is deceptively produced."²⁶ In their model, a single breach on quality can exact a heavy cost through the costless communication of the breach on the market. As discussed, market prices above the competitive price and the presence of non-salvageable capital are means of enforcing quality promises. Their model, however, does not deal with multiple bilateral transactions when one party faces numerous creditors. In the latter case, contractual devices have to deal with not only relations between the debtor and other creditors but also relations between creditors. In some other cases, legal devices also need to regulate the relations between secured creditors and purchasers for value in good face.

While Klein and Leffler focused on market forces in contract enforcement, Avner Grief's study of the relations between the Maghribi merchants and their overseas agents in the Mediterranean during the late medieval Commercial Revolution shows how a non-market reputation-based institution worked.²⁷ In his study, information sharing and multilateral punishment enabled credible commitment of agents to merchants *ex ante* and effective fulfillment of contractual obligations *ex post*.²⁸ Similar to Klein and Leffler, Grief does not deal with problems arising from multiple bilateral contractual relations.

In the case of mortgage, a mortgagor may use the same collateral to borrow money from different creditors. When the mortgagor defaults and the value of the collateral is unable to satisfy the claims of all the mortgagees, each mortgagee has the incentive to seize the collateral and realize its right ahead of other creditors. This collective action problem faced by secured creditors requires a third party enforcement regime. To solve the priority issue,

²⁶ Klein and Leffler, *supra* note 13, at 617.

²⁷ Avner Grief, "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Trader's Coalition", 83 *American Economic Review* 525 (1993).

²⁸ *Id.*

most countries have developed a formal regime. The normal rule is that the order of priority of the several mortgagees must be ascertained, and the first in priority paid in full before anything is given to those who rank below him in priority.²⁹ So far we have not seen an informal regime which is able to solve the priority competition issue between mortgagees efficiently.

The administration of the formal regime of mortgage law requires a functional court system. In addition, a separate registration system must be established so that mortgaged property can be registered. Such a registration system serves an important purpose of recording the sequence of all mortgaged property of a particular mortgagor. With this registration system, potential mortgagees, trade or financial creditors, can easily search whether a particular debtor has used the same asset to secure debts before. Without a registration system, creditors will have great difficulty finding out whether the debtor has used the same asset to secure debts. When creditors face great uncertainty, they will either reduce credit or lend at a higher interest rate. In either case, the cost of capital formation will be higher.

If a country cannot establish a registration system and a formal legal system, the device of secured debt has to be foregone. Economists claim the importance of the device of secured debt. First, secured debt may solve the debt erosion problem. As a secured lender can usually perfect its security interest easily when there is a registration system, it enjoys priority over subsequent lenders. As a result, the debtor cannot issue subsequent debt of equal or higher priority. Therefore, unless the secured creditor is under-secured, the opportunity to redistribute wealth by the debtor through subsequent debt financing is effectively neutralized.³⁰ In addition, security interests make the substitution of high-risk for low-risk assets after obtaining the loan more difficult.³¹ After obtaining the loan, the borrower may have the incentive to substitute projects with more variable cash flow for projects with less variable cash flow. As creditors are not able to share with the debtor the upside benefits

²⁹ Paul B. Fairst, 2nd ed., *Mortgages* (London: Sweet & Marwell, 1980), at 103 and 130; Art. 199 of the Law on Real Property in China, available at <http://www.chinalawinfo.com>; W D Duncan and Lindy Willmott, 2nd ed., *Mortgages Law in Australia* (Sydney: The Federation Press, 1996), at 142-46.

³⁰ Alan Schwartz, "Security Interests and Bankruptcy Priorities: A Review of Current Theories", 10 *Journal of Legal Studies* 1 (1981), at 31-33.

³¹ Clifford W. Smith and Jerold B. Warner, "Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment", 34 *Journal of Finance* 247 (1979), at 250.

from the borrower's asset substitution but must bear the downside risk, asset substitution transfers wealth from creditors to the debtor. If the debt is secured, however, those secured assets cannot be easily disposed of without permission of the secured creditor. Furthermore, secured debt can ameliorate the underinvestment problem.³² Some profitable projects will not be undertaken by a borrower which can use only equity or unsecured debt to finance them but will be undertaken if they can be financed with secured debt. Besides, secured interests over specific assets impair their marketability. This is so because the transfer of secured assets not made in the ordinary course of the debtor's business passes title to the purchaser subject to the perfected security interest.³³ Therefore, secured debt makes it difficult for the debtor to transfer wealth from secured creditors to itself. As secured debt serves important purposes of alleviating the above examined moral hazard problems, the inability of establishing a secured debt regime including mortgages results in a dead-weight social loss.

Williamson argues for the importance of using hostages to support exchange in informal contractual settings. He also cites Klein and Leffler's point that requiring franchisees to rent from the franchisor the outlet can reduce opportunistic behaviors on the part of the franchisee.³⁴ When the franchisee cheats on quality of the good or price, the franchisor can require the franchisee to move and "thereby impose a capital loss on him up to the amount of his initial non-salvageable investment on the outlet."³⁵ As discussed previously, Dnes's empirical study in the United Kingdom does not support Williamson's view.³⁶ Moreover, while hostages can be used to support exchange, they may also be abused. The person possessing the hostage may have the incentive to expropriate the hostage by creating conditions of contractual termination. In addition, the secured creditor may not have the incentive to make reasonable efforts in obtaining the best possible price on the market when disposing of the collateral, causing harm to the mortgagor and other mortgagees. When a formal legal regime is used to enforce law and

³² René M. Stulz and Herb Johnson, "An Analysis of Secured Debt", 14 *Journal of Financial Economics* 501 (1985), at 515-18.

³³ Triantis, *supra* note 23, at 247.

³⁴ Williamson, *supra* note 7, at 529.

³⁵ *Id.*

³⁶ Dnes, *supra* note 20.

contracts, using hostages to support exchange becomes unnecessary.

With respect to the potential of expropriating the hostage, both private contracts and formal law regulates such misbehavior. Contractual parties in the context of franchising in the United Kingdom insert arbitration, renewal, and asset-valuation clauses in their contracts to curb the potential abuse of the hostage.³⁷ Formal law in the United States also deals with such potential abuse of the hostage.³⁸

Formal legal also carefully regulates the misbehaviors of mortgagees caused by the lack of incentives in disposing of the mortgaged property. In the United Kingdom, a mortgagee is under a duty to take reasonable care to obtain the true market value of the mortgaged property.³⁹ A building society has a duty “to take reasonable care to ensure that the price for which the property is sold is the best price that can be reasonably obtained.”⁴⁰ Obviously, the law tries to solve the problem that the mortgagee may not have the incentive to sell the mortgaged property at a reasonable price, causing loss to the mortgagor or other mortgagees. In Australia, “a receiver owes duties to the mortgagor, primarily to exercise powers in good faith not sacrificing the mortgagor’s interest recklessly, to act strictly within the conditions of appointment, to account to the mortgagor for surplus after the discharge of securities and, if property is to be sold, a duty to obtain the best possible price.”⁴¹ In China, the Law on Real Property also requires that the sale of mortgaged property must be done with reference to the market price.⁴²

This section explains that the device of mortgages requires the support of a formal legal regime. Under a formal legal system, the use of hostages to support exchange becomes unnecessary. In addition, a formal legal system solves the problem of abusing the hostage relatively well. As the device of mortgages can solve many types of moral hazard problems after the debtor obtains the loan and secures well the principal and interest, secured debt of mortgages is widely used in many developed countries. The increasing use of

³⁷ *Id.*, at 380.

³⁸ For examples, see West’s Arkansas Code Annotated, A. C. A. § 4-72-310; West’s Ann. Cal. Bus. & Prof. Code §20020.

³⁹ *Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd.*, [1979] Ch. 948.

⁴⁰ *Fairest*, *supra* note 29, at 98.

⁴¹ *Duncan and Willmott*, *supra* note 29, at 94.

⁴² Law on Real Property, *supra* note 29, Art. 195(3).

mortgages in China also provides empirical evidence that mortgages facilitate bank lending. The precondition of developing a formal legal regime of mortgages is, however, the improvement in defining and enforcing property rights. The next section will examine the evolution of property rights in China. The section will then explain the relation between the increasing use of mortgages and the expansion of bank lending. Other things being equal, the greater the amount of banking lending, the higher the growth rate of the economy. The case of the developing legal regime of mortgages raises doubt on the claim that formal law does not play any meaningful role in China's economic development.

III. Mortgages Law and Bank Lending

In the last 10 years or so, as economic reform reaches a more mature stage in China, secured lending through mortgages, a more formal form of financial contract has become more widespread. In a recent study, Haselmann and his colleagues conducted an empirical study to examine the relationship between reform of bankruptcy law and collateral law and behavioral changes by banks in their lending activities.⁴³ One of the findings of their study is that 'collateral law designed to protect individual creditors' claims is of greater importance for expanding bank lending than is bankruptcy law, which is aimed at establishing a collective enforcement regime.⁴⁴ One implication of this study is that if secured lending contracts are legally enforceable, the adoption of them will increase bank credits as well as the quality of these credits. Before examining the growing use of mortgages in China, I will briefly discuss the developing legal framework on mortgages.

A. The Legal Framework

1. The law of mortgages on immovable property

As urban land is closely related to the real estate market and China's

⁴³ Rainer Haselmann et al., "How Law Affects Lending", 1 (Columbia Law and Economics Working Paper No. 285, 2006), available at <http://ssrn.com/abstract=846665>.

⁴⁴ Id, at 2.

high rate of economic growth, tracing the evolution of the ownership and transfer of real property will provide an institutional explanation of the role of property law. Despite the fact that neither the 1954 Constitution nor the 1978 Constitution states as clearly as the 1982 Constitution that urban land is owned by the state,⁴⁵ land use had been allocated by the government without any fee payment by users from 1954 to 1979.⁴⁶ As the scarcity of land was not well reflected by such an administrative allocation system, there was a great deal of waste.⁴⁷ The economic reform program initiated in 1978 started to pay attention to the issue of efficient land use. The Equity Joint Venture Law between Chinese Partners and Foreign Investors enacted in 1979 makes it possible for the Chinese partner to use land-use right as equity contribution.⁴⁸ If land-use right was not treated as equity contribution by the Chinese partner, the equity joint venture should pay fees for obtaining the land-use right to the Chinese government.⁴⁹ This was the starting point of changing the free urban land-use system. In 1982, Shenzhen began to charge land-use fees from users.⁵⁰ Since then, the practice of charging land-use fees has spread to the whole nation. Except for a few types of institutions, all profit-oriented enterprises have to pay land-use fee.⁵¹ While the initial purpose of charging land-use fee is to solve the shortage of capital for urban development, the greater significance of the adoption of land-use right system is the reshaping of the administrative allocation of land-use system.

The initial success of charging land-use fee prompted more changes related to land-use transfer. Although the land-use fee system was adopted, the 1982 Constitution still prohibited appropriation, buying and selling, or leasing of land or the transfer of land by other unlawful means.⁵² Article 80(3) of the General Principle of the Civil Law (GPCL) stipulates, among other things, that

⁴⁵ Art. 10 of the 1982 Constitution. Both the Chinese version and an English translation can be found at <http://www.chinalwinfo.com>.

⁴⁶ Wang Zuotang and Wang Wenzhen, "On the Reform of Land-use Right in Chinese Cities", 3 Beijing University Journal 16 (1990).

⁴⁷ *Id.*

⁴⁸ This Law is reprinted in the Collection of the Laws of the PRC (Jinlin: Jilin People's Press, 1949-1989), at 1239.

⁴⁹ *Id.*, Art. 5 of the Law.

⁵⁰ Sun Youhai, A Study of the Land Transfer System, Doctoral Thesis (Nanjing: Nanjing Agricultural University, 2006), at 29.

⁵¹ *Id.*

⁵² Art. 10 of the 1982 Constitution, *supra* note 45.

land cannot be purchased and sold, leased, or mortgaged.⁵³ In July 1987, however, the Office of the Special Economic Zones under the State Council proposed to the State Council that Shanghai, Tianjing, Guangzhou and Shenzhen should be used as trial cities to experiment with the transfer of land-use right system.⁵⁴ Under this system, applicants may acquire the right of using a specific piece of land for up to 50 years through bidding or auction, or by entering into an agreement with the relevant government upon the payment of a fee. Thereafter, the user may transfer the land-use right to another person for the remaining period.⁵⁵ In 1988, the 1982 Constitution was formally amended to permit the lawful transfer of land-use right.⁵⁶ Thereafter, the Law on the Administration of Land⁵⁷ was amended in 1988. One of the amendments was to establish the pay for land-use right system and to incorporate the constitutional amendment that land-use right can be lawfully transferred.⁵⁸ The State Council promulgated in 1990 the Provisional Regulation Concerning the Assignment and Transfer of Land-use Right of State-owned Land in Urban Areas.⁵⁹ Since then the system of pay for using land and the assignment and transfer of land-use right has been well established. The Law on the Administration of Urban Real Estate⁶⁰ enacted in 1994 and amended in 2007,⁶¹ and the Law on Real Rights⁶² enacted in 2007

⁵³ The GPCL was enacted in 1986. The Chinese version appears in the Collection of the Laws of the PRC (Jilin: Jilin People's Press, 1989), at 315. An English translation can be found at <http://www.chinalawinfo.com>.

⁵⁴ Sun Youhai, *supra* note 50, at 28-29.

⁵⁵ Regulation Concerning the Administration of Land in the Shenzhen Special Economic Zones, promulgated by the Standing Committee of Guangdong People's Congress on December 29, 1987, available at <http://www.law-lib.com/lawhtm/1988/49032.htm>.

⁵⁶ Art. 10 of the Constitution, *supra* note 45.

⁵⁷ This Law was initially enacted in 1986, reprinted in the Collection of the Laws of the PRC (Jilin: Jilin People's Press, 1949-1989), at 1872.

⁵⁸ Art. 1 of the Decision Concerning the Amendment of the Law on the Administration of Land; this Decision was approved by the Standing Committee of the National People's Congress on December 29, 1988, reprinted in the Collection of the Law of the PRC (Jilin: Jilin People's Press, 1949-1989), at 1978.

⁵⁹ An English translation can be found at <http://www.chinalawinfo.com>.

⁶⁰ An English translation can be found at <http://www.chinalawinfo.com>.

⁶¹ An English translation can be found at <http://www.chinalawinfo.com>.

⁶² *Supra* note 29. For an evolution of private property and an ideological debate on the protection of private property during the enactment of the Law on Real Rights, see Mo Zhang, "From Public to Private: The Newly Enacted Chinese Property Law and the Protection of Property Rights in China", 5 Berkeley Business Law Journal 317 (2008); for a legislative history and the content of the Law on Real Rights, see Gebhard M. Rehm & Hinrich Julius, "The New Chinese Property Rights Law: An Evaluation from a Continental Perspective", 22(2)

follow that system.

In addition to the establishment of the system of paying for using land and of the assignment and transfer of land-use right, the housing reform policy in urban areas has also contributed to the better definition and enforcement of property rights of urban real estate.

Before 1988, employees in urban areas all lived in houses or apartments allocated by their enterprises or institutions. They did not have ownership of the houses or apartments and only paid a symbolic rent. The success of market oriented reform in the areas of trade, investment, and employment led to the housing reform. The housing reform was initiated in 1988 when the State Council circulated the Notice Concerning the Implementation Plan of Promoting Housing Reform in Urban Areas.⁶³ While the immediate objective of the housing reform was to raise the rent, the long term objective was to realize the goal of allocating houses or apartments through the market.⁶⁴ In 1994, the State Council issued the Decision on Deepening the Reform of Urban Housing System.⁶⁵ The gist of the Decision was to incorporate the housing benefits into the salary of employees so that the high income families could buy commercial houses (*shangpinfang*) while the middle and low income families could purchase subsidized suitable economy houses (*jingji shiyongfang*) or lease low-rent apartments (*lianzufang*).⁶⁶ In addition, the Decision also instructed local governments to gradually establish the system of house accumulation fund (*zhufang gongjijin*)⁶⁷ to facilitate policy and commercial bank lending, and to regulate the real estate market.⁶⁸ Besides, the Decision also urged local governments to sell the then existing houses or apartments to employees.⁶⁹ Those who purchased the houses at market prices could later sell their houses right away while those who purchased their houses at cost should also be able to sell their houses in five

Columbia Journal of Asian Law 179 (2009).

⁶³ Available at <http://www.law110.com/law/guowuyuan/2083.htm>.

⁶⁴ Id.

⁶⁵ Available at <http://www.tsinghua.edu.cn/docsn/fcc/fgzcjzzgl>.

⁶⁶ Id.

⁶⁷ The house accumulation fund is contributed by employers and employees with no tax levy and can be used by employees to purchase houses and borrow lower interest loans. See Jia Kang and Liu Junmin, "A Study on the Issue of Housing Reform and Housing Security in China," 7 Finance and Politics Research 8 (2007), at 17.

⁶⁸ Decision, *supra* note 65.

⁶⁹ Id.

years time.⁷⁰ This Decision sent out a very clear signal to the urban residents that buying and selling houses on the market was the future direction. In 1998, the State Council issued the Notice Concerning the Further Deepening of Housing Reform and the Acceleration of Housing Construction in Urban Areas.⁷¹ This Notice urged local governments to terminate the internal allocation of housing property to employees.⁷² To address the problem that the least advantaged people in urban areas cannot afford to buy either commercial houses or subsidized suitable economy houses, the Notice required local governments or enterprises to provide low-rent houses to this group of residents.⁷³ Among other things, the Notice also instructed commercial banks to expand the scope of home-purchasing loans and the local governments to improve the system of registration of mortgage loans.

The housing reform has also led to the development of the real estate registration system. The early registration of land-use right and houses or apartments occurred at the local level. The Administrative Provisions on Commodity Housing in the Shenzhen Special Economic Zone was the earliest local law on the registration of housing ownership.⁷⁴ This local law contains detailed provisions regarding the registration of the ownership of houses, transfer of title, and mortgage of housing property.⁷⁵ The Regulation on the Administration of Land in the Shenzhen Special Economic Zone dealt with the registration of land-use right and mortgages of land-use right.⁷⁶ Shanghai, Guangzhou, and Beijing had similar local laws in the 1980s.⁷⁷ In 1994, the Law on the Administration of Urban Real Estate was enacted at the national level.⁷⁸ This Law requires the holders of land-use right or owners of housing property to register their property rights.⁷⁹ The assignment of land-use right, housing property, and the mortgage of these property rights shall also be

⁷⁰ Id.

⁷¹ Available at <http://www.law110.com/law/guowuyuan/2025.htm>.

⁷² Id.

⁷³ Id.

⁷⁴ The Provisions are reprinted in Yang Bingzhi ed., Guidelines on Real Estate Law 1322 (Beijing: Law Press, 1993).

⁷⁵ Id., Arts. 6, 14, 18-19, and 39-40.

⁷⁶ Id., Arts. 22, 27, and 29.

⁷⁷ Id.

⁷⁸ Supra note 60.

⁷⁹ Art. 60.

registered with the relevant authorities.⁸⁰ Currently, the registration offices in big cities provide relatively good access for the public to searching the title of land-use rights, the title of housing property, and the mortgage of land-use rights and housing properties.⁸¹ It goes without saying that the real estate registration system has significantly improved the definition of property rights. Furthermore, the registration system of real estate has also facilitated the provision of mortgage loans.

2. The law of mortgages on movable property

An important part of the financial reform in China is to reform the banking sector. In 1978, there were only two banks in China:⁸² the People's Bank of China, engaged in domestic banking, and the Bank of China, which dealt with foreign currency business.⁸³ Beginning in 1979, China reconstructed the previously dissolved Agricultural Bank of China and the Peoples' Construction Bank of China.⁸⁴ On January 1, 1980, the Industrial and Commercial Bank of China was established.⁸⁵ In 1983, the State Council decided to have the People's Bank of China solely exercise the functions of a central bank.⁸⁶ In 1984, the Industrial and Commercial Bank of China took

⁸⁰ The most recent administrative rule at the national level on land registration is the Land Registration Measures promulgated by the Ministry of Land and Resources on December 30, 2007. The Chinese version and an English translation of the Measures are available at China Law and Practice 47 (May 2008). The most recent administrative rule on housing title registration at the national level is the Measures for Building Registration. This Rule was promulgated by the Ministry of Construction on January 22, 2008 and became effective on July 1, 2008. It has replaced the Measures on the Administration of the Registration of Urban Housing Title promulgated by the Ministry of Construction on October 27, 1997 and amended on August 15, 2001. The Current Rule is available at <http://www.chinalawinfo.com>.

⁸¹ For an assessment and criticisms of and suggested changes to the land law in China, see Joyce Palomar, Land Tenure Security as a Market Stimulator in China Contents, 12 Duke Journal of Comparative and International Law 7 (2002).

⁸² Wu Jingling, "China's Economic and Financial Reform", in Financial Reform in China 85 (On Kit Tam ed., 1995).

⁸³ Wu Xiaoling, "China's Financial Institutions", Id., at 113.

⁸⁴ The People's Construction Bank of China, originally established in 1954, was absorbed by the Ministry of Finance in 1958. Established in 1955, the Agricultural Bank of China was dissolved in 1957 and its business was taken over by the People's Bank of China. These two banks re-emerged in the 1960s and continued only for a very short period. See Handbook of Financial Law Practice in China 26-27 (Sun Zhiyuan ed., 1994).

⁸⁵ Id. At 25.

⁸⁶ These Decisions were issued on Sept. 27, 1983. Decision of the State Council Concerning the Exercise of the Functions of the Central Bank by the People's Bank of China, reprinted in

over the commercial business from the People's Bank of China. Since then, the People's Bank of China has gradually become the central bank of China.⁸⁷ As a result of the banking reform, four specialized banks have emerged: the Agricultural Bank of China, the Bank of China, the Industrial and Commercial Bank of China, and the People's Construction Bank of China. Since the enactment of the Law on Commercial Banks in 1995, these specialized banks have become normal commercial banks.

By the end of 1993, these banks accounted for eighty percent of the total assets of the banking sector in China.⁸⁸ Encouraged to act more like commercial enterprises, these banks are, at least in theory, responsible for raising their own funds and paying interest to depositors.⁸⁹ Enterprises are no longer given an automatic right to credit and banks are to allocate funds on the basis of enterprise profitability.⁹⁰ To make loans more efficient, banks have started to adopt security devices including mortgages.⁹¹ Before turning to the statistics on the use of mortgage of movables in the next Part of this Section, I will briefly examine the law of mortgages on movables.

The General Principle of the Civil Law (GPCL)⁹² contains only one provision on mortgages. This article only provides the definition of mortgages and declares that people may adopt the device of mortgage to secure obligations. As it was difficult to apply this provision to resolve disputes on mortgages, the Supreme People's Court added five provisions when it issued the Opinion Concerning Several Issues related to the Implementation of the General Principles of the Civil Law (GPCL Opinion).⁹³ Article 115(1) of the

the Collection of the Laws of the People's Republic of China (Jilin: Jilin People's Press, 1989), at 1353.

⁸⁷ Id.

⁸⁸ Zhou Zhengqing, Explanations Concerning the Commercial Banking Law of the People's Republic of China, Address at the Thirteenth Session of the Eighth Standing Committee of the National People's Congress, (August 24, 1994).

⁸⁹ See David Eu, Comment, Financial Reforms and Corporate Governance in China, 34 Columbia Journal of Transactional Law 449 (1996), at 489.

⁹⁰ Id.

⁹¹ Bank of China, Lending Measures for Foreign Invested Enterprises, issued by the Bank of China on April 24, 1987, available at <http://www.infobank.cn>, legal database; Agricultural Bank of China, Provisional Measures on Lending with Mortgage or Guarantee, available at <http://www.infobank.cn>, legal database.

⁹² GPCL, *supra* note 53.

⁹³ The Opinion was adopted by the Adjudicative Committee of the Supreme Peoples' Court on January 26, 1988. Both the Chinese version and an English translation can be found at <http://www.chinalawinfo.com>.

GPCL Opinion provides that transfer of mortgaged property without the consent of the mortgagee is invalid. Article 115(2) specifies that priority competition among mortgagees is based on the sequence of the creation of mortgages. The GPCL Opinion, however, does not require the registration of mortgages. Obviously, such a system makes it hard for creditors to decide on whether to take mortgages as they are not able to search the registration from a third party about the borrower's past record of providing collaterals to other creditors.

When the utilization of mortgages increased and when participants and law makers gained experience, improvement of the law took place. In 1995, the Security Law was enacted.⁹⁴ Compared with the earlier law, this Security Law is far more detailed. In accordance with this law, borrowers can use machinery, means of transportation and other property to secure obligations.⁹⁵ For the first time, this Security Law dictates that the mortgage of means of transportation, machinery and other movable property of enterprises shall be registered.⁹⁶ Also according to this law, the mortgaged contract becomes effective upon registration. In 2000, the Supreme People's Court issued the Interpretation on Several Issues Concerning the Application of the Security Law⁹⁷ to clarify some unclear matters in the Security Law.

When the use of mortgages further increased and more disputes were dealt with by the courts, the Law on Real Rights⁹⁸ passed in 2007 further improved the law of mortgages. Pursuant to the Law on Real Rights, the mortgage of real property requires registration.⁹⁹ The rights and duties between the mortgagor and mortgagee with respect to the mortgage of real property are effective only upon registration.¹⁰⁰ With respect to movables, registration is optional. Non-registration of mortgage of movables, however, will not allow the mortgagee to defeat an innocent third party.¹⁰¹ The Law on

⁹⁴ Both the Chinese version and an English translation of the law are available at <http://www.chinalawinfo.com>.

⁹⁵ Id. Art. 34.

⁹⁶ Id. Arts. 41 and 42.

⁹⁷ The Chinese version and an English translation can be found at China Law & Practice, 24 (February 2001).

⁹⁸ Supra note 29.

⁹⁹ Id. Arts. 180 and 187.

¹⁰⁰ Id. 187.

¹⁰¹ Id. Art. 188.

Real Rights also adopted the floating mortgage concept whereby the present and future machinery, raw materials, semi-finished products or products of sole-proprietor, enterprises, or agricultural production operators can be mortgaged.¹⁰² It goes without saying that the Law on Real Rights has considerably enlarged the scope of mortgage of movable property.

The rule on priority competition is relatively clear and easy to administer in practice. In accordance with the Law on Real Rights, if the mortgage rights have been registered, the priority among mortgagees is determined by the sequence of registration.¹⁰³ If registration of several mortgages occurs on the same date, the claims of mortgagees shall be realized proportionally.¹⁰⁴ Between registered mortgagees and non-registered mortgagees, registered mortgagees prevail over non-registered mortgagees.¹⁰⁵ For non-registered mortgagees, the inadequate assets or proceeds of the debtor will be shared proportionally.¹⁰⁶

The above short description of the law of mortgage of movable property shows that the Chinese law of mortgage of movables adapted to changing circumstances. It evolved from the very beginning with a very vague provision to a relatively functional regime of mortgage law. The Chinese experience provides a good lesson that it may not be appropriate for developing countries to transplant very sophisticated Western law at the beginning of economic development or economic transition from a planned economy to a market oriented economy. What is important is for law makers, participants, and enforcement agencies to adapt and solve problems during the development process. When the value of asset increases, people tend to devote more resources to defining and enforcing property rights in mortgages. The Next part on statistical evidence will shed further light on this issue.

B. The Evidence and Explanations

1. Evidence on mortgage of immovable property

¹⁰² Id. Art. 181.

¹⁰³ Id. Art. 199(1).

¹⁰⁴ Id.

¹⁰⁵ Id. Art. 199(2).

¹⁰⁶ Id. Art. 199(3).

GDP, Fixed Asset Investment, and Investment in Urban Houses

Unit: 100 Million Yuan

Year	Gross Domestic Product (GDP)	GDP Growth Rate % (calculated at constant prices)	Total Investment in Fixed Assets	Growth Rate of Total Investment in Fixed Assets %	Investment in Urban Housing	Investment in Urban Housing in Total Fixed Asset Investment %
1986	10275.2	8.8	3120.6	22.7	219	7.0
1987	12058.6	11.6	3791.7	21.5	240	6.3
1988	15042.8	11.3	4735.8	25.4	-	-
1989	16992.3	4.1	4410.4	-7.2	359	8.1
1990	18667.8	3.8	4517.0	2.4	321	7.1
1991	21781.5	9.2	5594.5	23.9	406	7.25
1992	26923.5	14.2	8080.1	44.4	411	5.1
1993	35333.9	14	13072.3	61.8	637	4.9
1994	48197.9	13.1	17042.1	30.4	1446	8.5
1995	60793.7	10.9	20019.3	17.5	1303	6.5
1996	71176.6	10	22974.0	14.8	1407	6.1
1997	78973.0	9.3	24941.1	8.8	3509	14.1
1998	84402.3	7.8	28406.2	13.9	3799	13.4
1999	89677.1	7.6	29854.7	5.1	3718	12.5
2000	99214.6	8.4	32917.7	10.3	3608	11.0
2001	109655.2	8.3	37213.5	13.0	5616	15
2002	120332.7	9.1	43499.9	16.9	5319	12.2
2003	135822.8	10	55566.6	27.7	5078	9.1
2004	159878.3	10.1	70477.4	26.6	8919	12.6
2005	183084.8	10.2	88773.6	26.0	10727	12.1

Sources : Except for the last two columns, the data of this table come from the China Urban Construction Statistical Yearbook (China Architecture & Building Press, 2005) at 171. The data on investment in urban housing property come from various years in the China City Statistical Yearbook (Beijing: China Statistical Press).

The above table shows a relatively close correlation between the GDP growth rate and the growth rate of fixed asset investment. Higher growth rate of fixed asset investment are more likely to result in higher growth rate of GDP in the same year. This is true for all years except 1998. On the other hand, lower growth rate of fixed asset investment are more likely to result in lower growth rate of GDP in the same year. The best examples are 1989, 1990, and 1999.

This table has also confirmed the importance of investment in urban housing property in China's economic development. When fixed asset investment plays a very important role in China's economic development, the increasing proportion of investment in urban housing property in total fixed asset investment explains the growing importance of investment in urban housing property. The last column of the above table reveals that the proportion of investment in urban housing property in total fixed asset investment has been doubled since 1997 compared with that in the period from 1986 to 1996. Viewed from the property rights perspective, it is more difficult to have such a considerably increasing amount of investment in urban housing property without clear definition and enforcement of property rights in the property law system. The easy search of titles of land-use rights and housing property and of the burden of mortgage in such real property in large cities in China has significantly facilitated transactions in real estate assets.

The move towards market orientation in allocating land-use rights on the primary market provides good evidence of the improving definition and transfer of land-use rights. While administrative allocation of free land use remains, that proportion has been decreasing. The allocation of land-use rights with fee payment has become more and more relied upon. There are three main methods of allocating land-use rights in the latter case.¹⁰⁷ They include agreement between the relevant governmental authority and the land user, auction whereby the governmental authority publically sells the

¹⁰⁷ Provisional Regulation on the Allocation and Transfer of State-owned Land-Use Rights in Urban Areas, issued by the State Council on May 19, 1990. This Regulation is reprinted in the Collection of the Laws of the PRC, 1764 (Jilin: Jilin People's Press, 1990-1992). Later laws and regulations have followed these three methods of allocating land use rights with fee payment and to some extent have restricted the allocation of free land use.

land-use rights to the person who is willing to pay the highest price, and bidding where the government authority invites potential users to submit bids and the person who is willing to pay the highest price is normally chosen. In 1993, 152,676 hectares of land were allocated nationwide.¹⁰⁸ Among them, around 89,750 hectares were allocated by administrative methods for free use (*huabo*), accounting for 58.78%¹⁰⁹ while around 62,926 hectares were allocated through auction, bidding or agreement, occupying the remaining 41.22% (*churang*). In 2001, allocation of land through auction, bidding, or agreement accounted for 55.5 % of the total allocation of 164,000 hectares.¹¹⁰ Since then, allocation of land-use rights through *churang* has taken a dominant position.¹¹¹

Among the three methods of allocating land with pay, the method of agreement (*xieyi churang*) is becoming less significant. In 1987-88, allocation of land with pay through agreement accounted for 96.7% of the total area.¹¹² The percentage of 81.2% of the total land allocation in terms of size through agreement in 1992 remained very high.¹¹³ Since 2002, allocation of land-use rights through auctions and/or biddings have began to increase. The percentage of land allocation through auctions and/or biddings was 15% in 2002, 33% in 2003 and 50.9% in 2007 respectively.¹¹⁴ Higher prices in obtaining land-use rights for urban development reveal that users including developers have confidence in the security of their investment in real estate. Clear definition and transferability of property rights in real estate are the precondition for investment.

Cross country comparison provides further empirical evidence that formal law on property right is critical in economic development. Writing in the context of Peru, Do Soto has the view that the inability to produce capital is a stumbling block to economic development. The source of the problem lies

¹⁰⁸ Liu Shouying, "Property Rights in Land and Real Estate Market Development in China," a lecture delivered at the School of Law of Renmin University, available at <http://www.civillaw.com.cn/article/default.asp?id=41228> (last visited on November 10, 2008).

¹⁰⁹ Id.

¹¹⁰ Id.

¹¹¹ Id. In 2003, allocation of land-use rights through *churang* accounted for 74.79% of the total 258,860 hectares allocated to users. In 2006, allocation of land use rights through *churang* amounted to 71.5% of the total allocated land of 204277 hectares.

¹¹² Id.

¹¹³ Id.

¹¹⁴ Id.

in the legal system. He specifically provides:¹¹⁵

It is the law that detaches and fixes the economic potential of assets as a value separate from the material assets themselves and allows humans to discover and realize that potential. It is law that connects assets into financial and investment circuits. And it is the representation of assets fixed in legal property documents that gives them the power to create surplus value.

While informal systems of contractual arrangements may partly substitute or complement formal contract law,¹¹⁶ the cost of relying on an informal system of property rights to acquire and enforce land rights can be enormous. De Soto summarized the cost in the following:¹¹⁷

The range of choices open to informals when they decide to acquire land informally is limited. It also involves a tremendous waste of resources because of the high costs of invasion or informal land sales and the uncertainties inherent in illegality. The property rights acquired are diminished by a kind of legal apartheid. And the system is unstable because it does not protect the informals when others try to invade their land. The absence of a legal system of efficient property rights is detrimental to all.

The contrast between China and Peru related to the definition and transfer of property rights in land and houses provides good lessons for other developing countries.

Formal property law not only affects the security of investment in real estate but also influences the way people finance their investment in real property. Palomar observed that “when land titles and land tenure are secure, landholders may utilize their property rights as collateral for loans.”¹¹⁸ As the Chinese economy possesses strong characteristics of a dual economy in the sense that urban cities are relatively highly developed while rural areas are underdeveloped, a brief comparison between the outcomes resulting from the formal property law on land use is helpful.

Whereas the definition, transfer, and registration of property rights of land and housing property in urban areas are relatively certain as discussed in

¹¹⁵ Hernando De Soto, *The Mystery of Capital* 157 (New York: Basic Books, 2000).

¹¹⁶ For a detailed literature review, see Trebilcock and Leng, *supra* note 3.

¹¹⁷ Hernando De Soto, *The Other Path* 56 (New York: Harper & Row, Publishers, 1990).

¹¹⁸ Palomar, *supra* note 81, at 10-11.

the previous part, things are different in rural areas. There were restrictions on the conversion of rural land to land for non-agricultural use from 1987 to 2006. The dominant concern behind the restrictions is the worry about the quick depletion of arable land in a country with a huge population. Restrictions began to increase when the economy started to grow at a fast rate in the middle of 1980s. The 1986 Law on the Administration of Land still provided three methods of converting rural land to land for non-agricultural use.¹¹⁹ First, when state-owned enterprises and collectively-owned enterprises in urban areas establish joint enterprises (*lianying qiye*) with collectively-owned enterprises in rural areas and need to use collectively-owned land in rural areas, these joint enterprises may convert the rural land to state-owned land after giving compensation to farmers or the collectively-owned enterprises in the rural area may use the land use rights as equity contribution after obtaining governmental approval.¹²⁰ Second, housing construction in rural areas, construction related to the establishment of village (township) enterprises, construction of village (township) public infrastructure, or construction of village (township) public utilities or welfare projects can be carried out after obtaining governmental approval.¹²¹ Third, when non-rural residents in urban areas have to use collectively-owned land in rural areas for the purpose of housing construction, they may use land in rural areas after obtaining governmental approval.¹²² A Circular of the State Council in 2006 prohibited the conversion of land for agricultural use to land for non-agricultural use by means of leasing instead of expropriation which has been subject to stricter control.¹²³

In the 1998 Law on the Administration of Land, the third method discussed under the 1986 Law on the Administration of Land is no longer possible.¹²⁴ Related to the abolishment of this method of converting land from agricultural use to non-agricultural use in this law, using rural land for residential purposes both for farmers and urban residents is very restrictive.

¹¹⁹ Supra note 57.

¹²⁰ Id., Art. 36.

¹²¹ Id., Art. 37.

¹²² Id., Art. 41.

¹²³ Circular of the State Council on Strengthening the Control of Land, available at http://www.gov.cn/ztl/jqtdtk/content_379776.htm (last visited on November 14, 2008).

¹²⁴ The 1998 Law on the Administration of Land is reprinted in the Collection of the Laws of the PRC, (Jilin: Jilin People's Press, 1998), at 2051.

The 1986 Law on the Administration of Land provides that those farmer applicants who have sold or let their houses shall not be eligible for additional land for building houses.¹²⁵ The 1998 Law on the Administration of Land further adds a provision that each household shall only have one piece of household land (*Zhaijidi*).¹²⁶ Various governmental regulations or rules have also prohibited the purchase of rural houses by urban residents.¹²⁷

The very restrictive approach to the conversion of land from agricultural purpose to non-agricultural purposes and to the purchase of rural houses by urban residents turned many transactions into illegal or informal transactions. Despite some exceptions created by some local governments, using rural land as mortgage asset to finance various projects becomes very difficult.¹²⁸

The picture is very different in urban areas where land title and land tenure are relatively secure. The registration and search of land-use rights or housing title and mortgages of such assets are relatively easy. The statistical data of mortgages related to land use rights and housing property in urban China provide some empirical evidence on the positive correlation between the formal law of property rights and China's economic development. The following table shows the mortgage of land use rights in urban areas.

Mortgage of Land-use Rights in Urban China¹²⁹

Year	Total Land Turnover on the Secondary Market	Mortgage of Land-Use Rights (hectares)	Transfer of Land-Use Rights (hectares)	Leasing of Land-Use Rights (hectares)	Percentage of Mortgaged Land in Total Land

¹²⁵ 1986 Law on the Administration of Land, supra note 57, Art. 38.

¹²⁶ Supra note 124, Art. 62.

¹²⁷ Circular of the General Office of the State Council on Strengthening the Administration of Land Transfer and the Prohibition of Speculation and/or Sale of Land, issued in 1999 and available at http://www.bjtd.com/article_view.asp?article_ID=330 (last visited on November 14, 2008); Decision of the State Council on the Deepening of Reform and Strict Administration of Land, issued in 2004 and available at <http://www.people.com.cn/GB/shizheng/1026/3078631.html> (last visited on November 14, 2008); Huang Songyou, "People's Court Shall not Support the Purchase of Rural Houses by Urban Residents," a speech delivered at the Civil Adjudicative Work Conference held on April 9, 2007, available at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/legal/2007-04/10/content_5955994.htm (last visited on November 14, 2008).

¹²⁸ Liu Shouying, supra note 108.

¹²⁹ Id.

	(hectares)				Turnover
2001	2290000	2140435	139304	10261	93.7%
2002	372672	288821	66757	17272	77.5%
2003	1185168	1102207	69633	9055	93%
2004	3565376	3422761	66842	79876	96%

The above table shows that the mortgage of land-use rights plays a significant role in financing investment in the real estate sector in urban China. There is a positive correlation between the growth of real estate loans and the growth of real estate investment as reflected in the following table. It goes without saying that without the mortgages, the amount of loans from banks would have been considerably smaller.

Correlation between Real Estate Loans and Real Estate Investment¹³⁰

	1999	2000	2001	2002	2003	2004
Growth of real estate loans	39%	117%	35%	42%	37%	23%
Growth of real estate investment	14%	19%	27%	24%	30%	28%

In addition to the evidence on the mortgage of land-use rights in urban area, the increasing use of home mortgage for financing the purchase of housing property through bank loans has also contributed to economic growth. From 1999 to 2004, the average annual property development and home mortgage loans grew by 49%.¹³¹ By the end of 2004, the outstanding residential mortgage loans reached 1.6 trillion yuan, 83 times the amount in 1997.¹³² In 2005, the outstanding mortgage loans amounted to 1.84 trillion yuan, accounting for 10% of the GDP in that year.¹³³

With the high rate of economic development in China, the value of land-use rights and/or housing property has also increased rapidly. The

¹³⁰ Cheng Jiansheng, "Reviews on Housing Finance in China", available at <http://www.adb.org/PRCM/speech-pres/pboc-jiansheng.pdf> (last visited on November 15, 2008).

¹³¹ Limin Liu, *Housing Market in Urban China*, Master Thesis (University of Nevada, Reno, 2007), at 61.

¹³² Cheng Jiansheng, *supra* note 130.

¹³³ Limin Liu, *supra* note 131.

increasing value of such real estate in turn induces people to devote more resources to define or enforce their property rights. The following table on the increasing number of legal disputes dealt with by courts in China from 1987 to 2001 provides strong empirical evidence.¹³⁴ The trend is particularly obvious from 1991.

Real Property Disputes Dealt with by Chinese Courts

Year	Numbers
1987	71110
1988	68664
1989	68229
1990	55704
1991	53938
1992	58782
1993	67736
1994	82341
1995	94234
1996	109822
1997	120732
1998	140993
1999	155782
2000	165799
2001	172750

The discussion in this part shows the close correlation between policy and legal changes related to land-use rights and housing in urban areas and China's high rate of economic development. As urban residents in the past did not have ownership rights in their housing property which used to be small and crowded, reform in this area tend to be less difficult compared with reform of large state-owned enterprises, education reform or health care reform. The reform of the real estate market has obviously made most urban residents better off. The adoption of pay for using land has considerably increased the revenue of local governments. This in turn has provided great incentives for local governments to attract investment to their local areas. The relative easy

¹³⁴ The numbers in this table are compiled by the author based on the China Legal Yearbook from 1988 to 2002 (Beijing: Law Press).

transfer of land-use rights in land and housing has also facilitated investment on the part of enterprises or individuals. The developing legal regime of China's urban real estate market provides some support of Anderson and Hill's theory.¹³⁵ The dynamic ways of legal and property market development in China also indicate that the participants on China's real estate market are very adaptive. Decentralized experimentation in finding new ways of solving problems and making most parties in urban areas better off¹³⁶ in the reform process shows that adaptive efficiency¹³⁷ is vitally important in economic development and transition.

3. Evidence on mortgage of movable property

The following table provides some statistical evidence concerning the use of mortgage of movable property by enterprises in China from 1997 to 2005.

Table on Mortgage of Movables

Year	Mortgage of Movable Property (Contract Numbers)	Mortgage of Movable Property (Contract Amount)[Unit:10,000Yuan]
1997	92817	36685713
1998	114609	40903577
1999	117459	48210788
2000	98762	44129477
2001	91239	46672150
2002	86161	49811313

¹³⁵ Terry L. Anderson and P. J. Hill, "The Evolution of Property Rights: A Study of the American West", 18 *Journal of Law and Economics* 163, 176 (1979) (arguing that a comparison of the benefits and costs of defining and enforcing property rights explains and predicts the evolution of property institutions).

¹³⁶ China is currently trying to solve the problem that local governments expropriate land from farmers at prices much lower than market prices and then sell the land-use rights of the expropriated land to investors at higher market prices.

¹³⁷ North, *supra* note 1, at 80-81.

2003	86119	58757389
2004	73997	69958379
2005	69580	94098771

Source: Various years from the *Administration Yearbook of China Administration for Industry and Commerce* (Beijing: Press of the Industry and Commerce, 2000-2006).

The above table shows the increasing use of movable property as collateral for the purpose of securing loans. Although the number of contracts has declined since 1999, the value of contracts for the mortgage of movable property has been increasing except for the minor decrease in the year 2000. It is likely that the newly adopted floating mortgage device will further promote the use of movable property in bank lending.

C. Questionnaire Survey

One bank at the national level and seven bank branches or regional banks in Xian responded to my questionnaire survey.¹³⁸ When they were asked to explain the proportion of lending requiring security, seven responded that 75 to 100 % of the loans were secured; only one response suggested that 50 to 75 % of the loans were secured. When they were requested to explain whether the use of security will affect the provision of credit by banks, six responded that the use of security will very significantly increase the probability of lending; two replied that the use of security will significantly affect their lending decision. The questionnaire survey provides collaborative evidence that formal contractual arrangements of mortgage have been widely used in business transactions in China. Without the device of secured debts, many bank loans probably would not have occurred. This is especially true during China's high rate of economic growth when firms have to supply goods to new trading partners. With respect to new trading partners, it is far more uncertain whether the suppliers will enter into contracts with these new trading partners in the future. It is equally true in cases where loans are used for infrastructure projects as it is not certain that borrowers will repeatedly undertake similar projects in the future and repeat transactions are likely.

¹³⁸ The author conducted a Questionnaire survey in 2007.

The results of the questionnaire survey suggest the finding that secured lending is already an important part of overall lending by banks today. This is not surprising given the current economic development in China regarding economic actors. It is difficult for banks to establish the appropriate credit rating for borrowers and borrowing firms. Financial reporting procedures are not well-established by firms. Most firms are brand new or relatively new firms. There is insufficient formal information about prospects of proposed investment projects. To protect themselves, banks demand collaterals, without which there would be no lending or much reduced lending. However, the collaterals are of no value if the contracts governing them cannot be enforced. Thus, the increased use of secured lending, a more formal financial contract, is to meet the demand for credit from borrowers without putting lenders at an unacceptable risk. The development of secured lending in the last 20 years in China appears to be consistent with North's notion of adaptive efficiency.¹³⁹

IV. Conclusion

This article has examined the increasing definition and enforcement of property rights in China. When the economy develops, people tend to devote more resources to clarifying the property rights of immovable property and movable property. The evidence is relatively clear that there is a positive correlation between the development of the formal legal regime and the expansion of bank lending. In this process, the developing legal regime on property rights has made an important contribution to China's economic development. Without the development of the regime of formal contract and property law, it is much more difficult that China would have had such a high rate of economic growth during the last 30 years. In this sense, this article differs from the view that the formal laws related to contract and property rights do not contribute to China's economic development. The evidence from China has implications to other developing or transitional economies that economic development requires a developing legal regime on contracts¹⁴⁰ and property rights. The development of formal law on property rights in China also shows the importance of adaptive efficiency of law making and enforcement. Shaped by the political goal of economic development, formal law on property rights began to change in China. Changes, however, normally

¹³⁹ North, *supra* note 1, at 80-81.

¹⁴⁰ For a discussion on the role of contract law in China's economic development, see Yu and Zhang, *supra* note 2.

occur in a piecemeal way by adapting to changing circumstances and learning from the past experience and lessons. The Chinese experience provides a good lesson that it may not be appropriate for developing countries to transplant very sophisticated Western law at the beginning of economic development or economic transition from planned economy to a market oriented economy. What is important is for law makers, participants on the market, and enforcement agencies to adapt and solve bottleneck problems during the development process. While Milhaupt and Pistor disagree with the static model that good law and enforcement necessarily mean good economic outcome, they do hold the view that the “relationship between law and markets” is a “highly iterative process of action and strategic reaction.”¹⁴¹ Their dynamic approach to the relationship between law and markets from a comparative corporate governance perspective is very similar to my approach of explaining adaptive efficiency in law making and enforcement in China related to the development of the urban real estate market in this article and contract law development elsewhere.¹⁴² Another implication from the Chinese experience for relatively large countries like Russia, India, and Brazil is that changes on the national level usually follow successful decentralized experiments at local levels.

¹⁴¹ Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World* (Chicago: The University of Chicago Press, 2008), at pp. 5-6.

¹⁴² Yu and Zhang, *supra* note 2.